Under Section 21(a) of the Exchange Act

REPORT OF INVESTIGATION IN THE MATTER OF THE CITY OF SAN DIEGO, CALIFORNIA

I. Introduction

The staff of the Division of the Enforcement has conducted an investigation into various events over the period 1996 through 2003 involving material misrepresentations and omissions in connection with the offer and sale of certain municipal securities, including those issued by the City of San Diego [City]. Based upon information obtained during the investigation, including investigative reports of the City Attorney of the City, and investigative reports of a law firm retained by the City to examine the adequacy of the City's financial disclosure as it relates to the pension system, the Securities and Exchange Commission [Commission or SEC] deems it appropriate that it issue this Report of Investigation [Report] pursuant to section 21(a) of the Securities Exchange Act of 1934 [Exchange Act] regarding the matters associated with the City's disclosures relating to its pension system and its wastewater system and remedial actions the City has taken in response to being advised of failures in its disclosure process that led to materially misleading disclosures.

Public entities issuing municipal securities are primarily liable for the content of their disclosure documents and are subject to the anti-fraud provisions under the federal securities laws against false and misleading statements. See Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Securities Act Rel. No. 7049, 59 FR 12748 (March 17, 1994). The SEC has previously stated that "public officials of the issuer who have ultimate authority to approve such municipal securities and related disclosure documents may not authorize disclosure that the public official knows to be false; nor may a public official authorize disclosure while recklessly disregarding facts that indicate there is a risk that the disclosure may be misleading." See County of Orange, California, Exchange Act Rel. No. 36761 (Jan 24, 1996), 61 SEC Docket 487.

II. Background

This Report concerns false and misleading statements that have been made since 1996 in the offer and sale of municipal securities that are secured by the City's General Fund, and false and misleading statements that have been made since 1996 in the offer and sale of municipal securities that are secured by the City's Wastewater Enterprise. The City made material misstatements in the disclosure documents for the offerings [General Fund Official Statements] or authorized the use of General Fund Official Statements that were either false or misleading by omitting to state material facts regarding: (1) the magnitude of the City's pension under funding; (2) the use of surplus earnings to pay pension benefits; (3) the effect of the pension under funding on the City's current and future budgets; and (4) the legality of the creation of pension benefits without a corresponding funding mechanism. The City also made material misstatements in the disclosure documents for the Wastewater System [Wastewater Official Statements] or authorized the use of Wastewater Official Statements that were either false or misleading by omitting to state material facts regarding: (1) the compliance of the City's rate structure with the applicable provisions of Federal and State law, including that the City was not charging certain of its customers the proportionate cost of providing the service attributable to such customers' parcels, and (2) the compliance of the City's rate structure with the provisions of Article XIIIC and Article XIII D of the California Constitution [Proposition 218].

The City's Pension System Under Funding

The City Attorney for the City of San Diego is authorized and obligated, pursuant to section 40 of the San Diego City Charter, to "be the chief legal adviser of, and attorney for the City" and "defend . . . all suits or cases to which the City may be a party." Pursuant to such authority, the City Attorney has requested that the Commission consider an offer of settlement with respect to the City, notwithstanding that there may be additional action taken by the Commission against the City Council (as a governmental body), individual City Council members, and various City officials and employees. We have carefully considered that request and have concluded, for the reasons explained below, that it is appropriate at this time for the Commission to accept the offer of settlement proposed by the City.

The City's financial statements for the fiscal year ended June 30, 2003, are being audited by KPMG LLP [KPMG]. That audit is not yet complete, and until it is complete, the City cannot access the public financial markets (the City has sold securities to a commercial bank pursuant to two separate private placements). KPMG, pursuant to AICPA Professional Standard AU section 317, *Illegal Acts by Clients*, has advised the City that it cannot complete its audit until there has been "an investigation . . . of sufficient scope and thoroughness to provide a sound basis for concluding either that illegal acts with relevance to the City's financial reporting have not occurred or that appropriate remedial action has been taken with respect to any conduct which the City and its counsel cannot definitively conclude was legal."[1] The City had hired Vinson & Elkins, L.L.P. [V&E] to conduct an investigation of the City's disclosure practices as they related to the City's obligation to fund its pension system for the period 1996-2004, and V&E completed this report on September 16, 2004 [First V&E Report]. KPMG reviewed that report and concluded that it is insufficient for their AU section 317 purposes. In addition, there was a series of correspondence between KPMG and V&E that resulted in a deterioration in the relationship between these two parties to the detriment of the City, with KPMG advising the City

1 Letter from Steven G. DeVetter, Partner, KPMG LLP, to Leslie J. Girard, Assistant City Attorney, dated Oct. 11, 2004.

that "[i]f the City is prepared to proceed with an appropriate investigation, then we urge you to consider retaining counsel other than V&E to do so [because] . . . conducting the kind of investigation that is necessary may be in tension with V&E's ongoing representation of the City in the pending SEC investigation."[2] Regardless of the merits of the respective positions of V&E and KPMG, the result has been the continuing failure of the City to have audited fiscal year 2003 financial statements, to the detriment of the citizens of the City.

In response to concerns raised by KPMG regarding AU section 317, the City Attorney conducted an investigation that to date has produced six interim reports. In Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials, the City Attorney concluded that substantial evidence exists that former Mayor Dick Murphy and some members of the City Council engaged in civil violations of federal anti-fraud and securities laws. In making this finding, the City Attorney determined that a critical factor in assessing the culpability of each official was his or her relevant training and knowledge of finance and securities law.[3]

In light of the fact that the First V&E Report and the City Attorney's report no. 2 reached somewhat different conclusions regarding the conduct of the Mayor and the City Council (and, in later reports, of other City officials and employees), the City has hired an independent Audit Committee to review all the reports and to conduct whatever additional investigations or procedures are necessary to assist KPMG in satisfying its obligations under AU 317. As part of that process, the independent Audit Committee engaged V&E to provide supporting

---

[2] Letter from Steven G. DeVetter to the Honorable Dick Murphy, Mayor, dated Oct. 29, 2004.

[3] Michael J. Aguirre, San Diego City Attorney, "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials," February 9, 2005, pp. 106-110.

documentation for the conclusions reached in the First V&E Report and to conduct certain additional procedures. The results of that additional engagement were set forth in a second V&E report dated (July 15, 2005) and entitled "Potential Violations of the Federal Securities Laws by the City of San Diego and Associated Individuals" [Second V&E Report]. In the Second V&E Report, the following conclusions were set forth:

- The Evidence Available to the Investigation is sufficient to support a conclusion that the City's disclosure was materially deficient in that it failed to inform the markets of critical facts that, absent painful corrective action by the City, threatened its pension system with escalating deficits.

- The Evidence Available to the Investigation supports a conclusion that Mr. Ryan (former City Auditor) and Ms. Webster (former Deputy City Auditor) acted negligently in connection with the disclosure deficiencies in the City's FY 2002 CAFR. Further, based on the Evidence Available to the Investigation, it is possible that a trier of fact could conclude that Mr. Ryan, and with a lesser degree of likelihood, Ms. Webster, acted in a reckless manner in that connection.

- The weight of the Evidence Available to the Investigation indicates that Ms. Vattimo (former City Treasurer) acted in a negligent manner in connection with the City's FY 2003 financial disclosure.

- The Evidence Available to the Investigation supports a conclusion that both Mr. Uberagua (former City Manager) and Ms. Frazier (former Deputy City Manager for Finance) acted negligently in connection with the City's FY 2003 public offerings.

- Applying the standard articulated by the Commission in the *Orange County* report, it is arguable that the Mayor and City Council failed to exercise proper care in discharging their responsibility to oversee the City's public disclosure.

- The additional evidence (examined for the Second V&E Report), in our view, falls short of establishing that the City's flawed disclosure resulted from intentional wrongdoing on the part of City employees.

The respective conclusions of the two V&E reports and the various reports of the City Attorney are currently being considered by the Audit Committee. The Audit Committee also is considering the necessity of additional investigative procedures and for that purpose the Audit Committee has engaged separate counsel. In the meantime, however, the City continues to suffer from the uncertainty of the various pending investigations to the detriment of the City's financial well-being. For the reasons outlined below, the Commission has determined that in light of the unprecedented significant remedial actions that have been undertaken by the City, it is appropriate at this time to accept the City's offer of settlement. Such offer is accepted without any comment on the relative merits of the conclusions reached in the two V&E reports and the various reports of the City Attorney. The ultimate determinations by the Commission regarding any culpability of the City Council, the Mayor, and various City employees and officials will be determined at a later date after the Commission has had the benefit of reviewing the Audit Committee's final report. But regardless of any culpability of such persons and of the degree of any such culpability, it is appropriate and in the best interests of the Commission, the City, the investing public, and the financial markets for the Commission to accept the City's offer of settlement. In doing so, the Commission encourages other municipalities to carefully consider the remedial steps undertaken by the City in an attempt to ensure the accuracy of its financial disclosures.

The Wastewater System Rate Structure

The City provides wastewater treatment for the Municipal Sewer System, which is a municipal sewage collection system for the City's residents [referred to herein as "retail" users] and the Metropolitan System, which is a regional sewage collection, treatment and disposal system to serve various Participating Agency users [i.e. neighboring cities, and herein referred to as "wholesale" users]. The City is a participant in the Federal Clean Water Grant program, and has been a participant since the early 1970's. The City is also a participant in the State's Revolving low-interest loan [SRF] program. The City received a total of seventeen separate federal and State Clean Water grants, and eight SRF loans since the program's inception. The value of the grants and loans totaled $266 million. As a condition of receiving the Clean Water Grants and as a covenant in the SRF loan agreements, the City was required to implement and maintain an approved wastewater user charge system that met certain proportionality requirements. These regulations require user charge systems must recover all costs of operation and maintenance from system users on a basis proportionate to use (i.e. users must pay for overall system processing, measured in terms of flow volumes, solids and organic loads)

In 1991, the City billed wholesale and retail users based on flow volume and total suspended solids. In 1998, the City entered into an agreement with the wholesale users (Participating Agencies) to identify and add a third cost component, "organics," for the purpose of calculating sewer bills, and this rate structure was approved by the State Water Resources Control Board [SWRCB] However the City did not implement necessary measures to bring its retail rate structure into compliance with federal or State requirements, and did not include in its retail system any specific cost recovery component for organics.

On November 26, 2003 and then again on March 17, 2004, the City received letters from the SWRCB requesting confirmation of whether the City had implemented a SWRCB rate structure, and stating that failure to do so could risk acceleration of the loans that the City received from the SWRCB. In June 2004, the City added an organic cost component to its formula for calculating its Municipal sewer customer's bills (retail). In June 2004, a class action lawsuit, *Shames v. City of San Diego*, alleging constitutional and contract claims and seeking a refund for single family residents. Plaintiff alleges that because the City failed until 2004 to factor the cost of organics in its billing formula, single family users were paying more than their proportional cost of service, while some commercial/industrial users were paying less than their proportional cost of service.

This litigation is currently before the court and also voluntarily before a retired federal magistrate acting as a mediator.

For the reasons outlined below, the Commission has determined that in light of the unprecedented significant remedial actions that have been undertaken by the City, it is appropriate at this time to accept the City's offer of settlement. Such offer is accepted without any comment on the issues relative to the Wastewater System. The ultimate determinations by the Commission regarding any culpability of the City Council, the Mayor, and various City employees and officials will be determined at a later date after the Commission has had the benefit of reviewing any Audit Committee's final report. But regardless of any culpability of such persons and of the degree of any such culpability, it is appropriate and in the best interests of the Commission, the City, the investing public, and the financial markets for the Commission to accept the City's offer of settlement. In doing so, the Commission encourages other municipalities to carefully consider the remedial steps undertaken by the City in an attempt to ensure the accuracy of its financial disclosures.

Facts Concerning the City's Pension System Under Funding

The City of San Diego is a municipal corporation governed by its own charter, the supreme law of the city, and enjoying all the powers, functions, rights, privileges, and immunities authorized by the Constitution and laws of the State of California. (City of San Diego Charter Art. I, §I.) Under Article XI of the California Constitution, a charter city such as San Diego exercises exclusive authority over all municipal affairs and has the power to issue debt and make and enforce all ordinances and regulations affecting municipal affairs subject only to the limitations provided in its charter. (Cal.Const. art. XI, § 5(a).) For the most part, charter city ordinances and regulations regarding municipal affairs prevail over state law covering the same issues.

All legislative powers of the City that are not reserved to the people by the State Constitution or the Charter are invested in the nine-member, full-time City Council, who are elected for staggered four-year terms. The Mayor and the eight members who represent districts in the City may serve no longer than two full terms.

The City Manager, who is appointed by the Council for an indefinite term, is the City's chief administrative officer.

The City of San Diego is required to make annual contributions to its Employees' Retirement System [SDCERS], a multi-employer defined benefit pension plan established by the City in 1927 to provide retirement benefits to its members. SDCERS is administered as a trust under California law. (Cal. Const. Art. XVI, § 17; City Charter art. IX, § 145.) The City is the plan sponsor. Although the City Council is responsible for determining the level of contribution and benefits for plan members, a board of trustees administers SDCERS. As part of its duties, the board retains an actuary to evaluate its assets and liabilities, and in its fiduciary capacity, the board approves the actuary's methodology and assumptions. There is no "trust" document beyond the Municipal Code sections that discuss the SDCERS fund. (*See* Municipal Code, §§ 24.0100 *et seq.)*

SDCERS is governed by three main sources of law: the California Constitution, art. XVI, § 17; the San Diego City Charter, art. IX, §§ 141 through 148.1, and art. X, §1; and the Municipal Code, §§ 24.0100 *et seq.* Board members have a constitutional duty to act in furtherance of three main goals: providing benefits to plan members, keeping employer contributions low and minimizing the cost of system operations under the California Constitution. The SDCERS Board's duty to its participants takes precedence over any other duty. (Cal. Const. art. XVI, § 17).

As with any financial plan, the viability of SDCERS is determined by the relationship between its assets and liabilities. SDCERS assets are the funds that have been contributed by the

City and its employees plus the return earned on investing those funds. SDCERS liabilities are the present value of the estimated future annual benefits owed to the beneficiaries.

As of June 30, 2004 (Fiscal Year 2004), SDCERS had $4 billion in actuarial liabilities and $2.63 billion in actuarial assets utilizing the Projected Unit Credit "PUC" method. The difference is $1.37 billion.[4] The pension deficit is the unfunded actuarial accrued liability [UAAL]. It should be noted that unless amortized appropriately the deficit will grow due to interest accrued on the UAAL.

The funded ratio is the actuarial value of assets expressed as a percentage of the actuarial liabilities. If SDCERS were 100 percent funded, the assets would equal the liabilities. As of June 30, 2004 (fiscal year 2004), SDCERS was 65.6 percent funded. The system was over 90 percent funded until fiscal year 2001. Significantly, in fiscal year 2002 the funded ratio dipped to 77.3 percent and then 65.8 percent in fiscal year 2003 after implementation of MPII (discussed below).[5] The cumulative financial impact of MPI (as described below) and MPII as of June 30, 2003 was $467.3 million.[6] This is due to the cost of the retroactive increase in benefits. This benefit increase is reflected in the difference between the median annual allowance of $28,184 for 5,723 retirees as of June 30, 2004 and $44,307 for the 313 new retirees during that year.[7]

Five factors have been the primary cause of the $1.37 billion deficit: (1) the City Council created retroactive benefits without increasing the annual contribution to fund them (41 percent); (2) the SDCERS Board approved the use of inappropriate actuarial assumptions and calculations

4 "SDCERS Annual Actuarial Valuation," June 30, 2004, p. 9

5 *Id.* at 13.

6 Letter from Rick Roeder to City of San Diego Pension Reform Committee of 4/20/04.

7 "SDCERS Annual Actuarial Valuation," June 30, 2004, p. 35.

(31 percent); (3) the City Council's decision to utilize plan earnings to fulfill other financial obligations (12 percent); (4) the City Council and SDCERS Board agreeing to a less than full actuarial contribution by the City (embodied in the MPI and MPII agreements) (10 percent); and (5) the City's annual contribution to the plan not including sufficient funds to pay either the principal or interest on the UAAL.[8] All five of these arise out of two primary problems with the management of the plan: creation of benefits without providing a funding source, and intentionally understating the problem.

When the City agreed to increase the annual multiplier rate as it did in 1996 (MP1) and 2002 (MP2), this augmented pension benefit was applied retroactively to all members of the affected class of employees, regardless of what they and the City agreed upon when they were hired. This created an immediate cost to the system which today totals almost $500 million for which no funding source was identified.

A secondary cause of the pension deficit is the fact that the actuarial assumptions and calculations approved by the SDCERS Board did not comport with reality. The employee turnover was less than forecast and the pay increases exceeded assumptions. In addition, there were significant "purchases of service credit" at a rate far less than the costs indicated by the actuary.[9] A purchase of service credit allows an employee to "buy years," thus allowing a fifteen-year employee, for example, to be treated identically to a twenty-year employee for pension purposes, with a corresponding increase in benefits. The use of unrealistic actuarial numbers was a concerted effort by the Board and the City to mask the drain on the plan for the benefit of the

8 City of San Diego Pension Reform Committee Final Report, September 15, 2004, p. 28.

9 Letter from Rick Roeder to Pension Reform Committee of May 4, 2004.

City budget. "[T]he City took advantage of certain vagaries of 'actuarial science' and pension accounting to further minimize its contributions to SDCERS." [10]

> The history of the relationship between the City of San Diego and SDCERS plays out as a series of initiatives by the City to reduce (at least in the short term) its contributions to the System, typically in response either to economic conditions that caused budgetary strain or to concessions made to the City's labor organizations. Many of these initiatives have been supported by the labor representatives on the Board. The result in each case was the postponement of difficult budgetary decisions into the future, often exacerbating the problems through the delay in confronting them."[11]

A critical component of achieving stability in a pension system is the assumed rate of return on assets. The greater the investment return, the less the participants must contribute to fund projected benefits. The projected rates of return, like all actuarial assumptions, are not an exact science. Inherent in the analysis is the assumption that over time the fluctuation or variation from the assumptions will average out. The creation of "surplus" earnings flies in the face of this bedrock concept. The reality is that any diversion of earnings from the system--no matter what label is attached to it--creates a liability which will eventually require funding.

SDCERS Retirement System Administrator Lawrence Grissom obviously recognized this and advised the Board in April 2002 "[I] believe there has come a perception over the years that

---

[10] Paul S. Maco and Richard C. Sauer, Vinson & Elkins, *Report on Investigation, The City of San Diego, California's Disclosures of Obligation to Fund the San Diego City Employees' Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code*, [Vinson & Elkins Report], September 16, 2004, p. 5.

[11] *Id*. at 38.

earnings are cash in pocket, which is not the case."[12] This was echoed by SDCERS attorney who opined:

> "Defining [s]urplus on a cash basis leads to draining off liquid assets and reducing future earning power. It also undercuts actuarial assumptions about earnings. An assumption of earnings is based on expected averages over a long period of time. By draining off cash in good years, the structure makes it harder to meet the long term earnings assumption."[13]

Use of this "surplus" (in spite of best accounting practices) became a recurring theme as other uses were found for these funds through the years. In 1982, when the City withdrew from the Social Security System, it was required to provide medical benefits. Once again, rather than have this expense be borne by the City budget, the surplus earnings were tapped.[14] This practice continued until this fiscal year. As a result the SDCERS Retirement Fund has been liable for these health care costs. From 1998 to 2000, further uses were found for the surplus earnings, including funding cost of living increase for retirees and to pick up a portion of the employees contributions. These funds were also designated to fund settlement of a lawsuit brought by some SDCERS members who asserted that the Board failed to include all appropriate compensation in determining annual benefits (commonly referred to as the "Corbett" settlement). All of these

---

12 SDCERS Board Meeting, Minutes, April 19, 2002, p. 26.

13 Letter from Constance M. Hiatt, Hanson Bridget Marcus Vlahos and Rudy ("Hanson Bridgett") to SDCERS, General Counsel Loraine Chapin of April 16, 2002.

14 San Diego Ordinance O-15758 (June 1, 1982).

contingent commitments of surplus earnings are arranged in a hierarchy referred to as the "waterfall."[15]

During 1996 labor negotiations, the City and the Board entered into an agreement with a two-fold disastrous impact. The City granted additional benefits resulting in significant increase in liabilities and SDCERS Board allowed the City to contribute less than the full amount of its annual obligation to the system (MPI). When MPI was entered into in 1996, the plan was more than 90 percent funded with many years of record earnings exceeding expectations.[16] However, the downturn in the market that began in 2000 resulted in an expectation that the fund ratio floor of 82.3 percent (a floor put in place by MPI) would be triggered, thus requiring the City to make up the shortfall. In order to avoid this obligation and have the Board agree not to enforce MPI, the City made matters worse by granting more benefits without corresponding funding, adding yet further to the plan liabilities (MPII).[17] The fund ratio then dipped to 77.3 percent in Fiscal Year 2002.[18]

Because the City's annual contributions to the Retirement Fund have not included either the principal or interest on the deficit, the Pension Reform Committee estimated that for the then $1.167 billion UAAL, the additional amount which should have been paid was: $93.3 million in interest on the UAAL, and $33.3 in contingent benefits previously paid from the "surplus" earnings for a total, along with other accrued costs, of $202.67 million. This figure does not

---

15 San Diego Municipal Code [SDMC] §24.1502.

16 "SDCERS Annual Actuarial Valuation," June 30, 2004, p. 13.

17 Michael J. Aguirre, San Diego City Attorney, "Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials," February 9, 2005, pp. 9 – 17.

18 "SDCERS Annual Actuarial Valuation," June 30, 2004, p. 13.

include any funds to reduce the UAAL, only to contain it.[19] The City's response: it paid only $85 million of the $202.67 million owed.[20]

The UAAL continued to grow exponentially as the City failed to pay even the purposefully understated amount due and continued to grant additional benefits. This combination of underpayment while simultaneously increasing contractually-obligated benefits has put the City in the financial crisis.

Description of MP1

In the spring of 1996, the City conducted negotiations with its labor unions for the terms of the City's labor contracts. Through the "meet and confer" process, the City granted several new retirement benefits to the unions. Among these benefits were, most notably: 1) significant increases in the formula for calculating the basic pension benefit, including an increase in the year multiplier from 1.45 percent to 2.00 percent per creditable year of service for general city employees; 2) the agreement of the City to implement the so-called Deferred Retirement Option Plan [DROP], by which employees could "double-dip" by banking retirement payments before they were actually retired, and receive a guaranteed interest rate on those payments for life; 3) an expansion of the "purchase of service credit" benefit under which employees could buy up to five years of "air time" and be treated, for retirement purposes, as having worked more years than he or she actually had worked, and 4) an increase in the "cap" on the 13th check for former city employees who retired prior to October 6, 1980.

The granting of these new benefits was conditioned on the agreement of the SDCERS Board to an "Employer Contribution Rate Stabilization Plan" [commonly referred to as

---

19 City of San Diego Pension Reform Committee, *Final Report*, September 15, 2004, p. 9.

20 *Id*. at 10.

Manager's Proposal I, or "MPI"], an agreement required by the City Manager. This was in spite of the fact that the Board's fiduciary duties logically had nothing to do with the meet and confer process between the labor unions and the City.

By MPI's terms, rather than contribute to the Retirement Fund the legally-required amount calculated by an actuary, the City made contributions to SDCERS based on an artificial, negotiated rate. Using the non-actuarial rate, the City's annual contribution for fiscal year 1996 would remain at the prior year's rate of 7.08. In the next year, 1997, the rate would be 7.33 percent. In following years, the City's annual contribution would increase by .5 percent each year until the City reached an Entry Age Normal [EAN] contribution rate, which would be closer to an actuarially-established rate. This transition period was to take ten years, ending in 2008. At that point, the City would agree to use an actuarially-based rate in all future years.

In addition, MPI added a "trigger" provision, set at 82.3 percent. If the funded ratio of the Retirement Fund dropped below 82.3 percent, the City contribution rate would be increased to an "amount determined by the actuary necessary to restore a funded ratio no more than the level that is 10 percent below the funded ratio calculated at the June 30, 1996 actuarial valuation." Notably, there was disagreement as to what this provision meant. Using one interpretation, if the trigger were hit, the City would restore the funded ratio to the 82.3 percent level by making a lump-sum payment. Using another interpretation, the City would pay at a full Projected Unit Credit [PUC] rate in the following fiscal year. Regardless of the interpretation, MPI was designed to avoid having to pay an actuarially-determined rate and to push debt onto future fiscal years.

The Corbett Litigation

On July 16, 1998, litigation was filed against the City (*Corbett v. City Employees' Retirement System, et al*) following a California Supreme Court ruling in *Ventura Deputy Sheriffs' Association v. Ventura Co. Board of Retirement* (16 Cal.4th 483 (1997)), which held that employee "final compensation" for purposes of determining pension benefits should include not only base salary but additional components of compensation such as overtime pay and sick leave. The Corbett litigation was settled in 2000, and involved lump sum payments and certain other adjustments to be included in payments to employees and retirees.

The Corbett settlement increased the City's liability to the pension system by approximately $260 million. At the time, this caused the funded ratio to decline from approximately 104 percent to 97 percent. However, this calculation did not include certain "contingent" aspects of the settlement which were estimated at approximately $70 to $75 million by the system's actuary. The contingent payments referred to certain payments that would be made to a specified population of retirees when the pension system generated surplus earnings. If there were no surplus earnings the benefits would continue to accrue until paid. The impact of including the "contingent" nature of the transaction would have reduced the funded ratio by another 2 to 2 ½ percent. This treatment was opposed by the system actuary, who suggested that the payment of the so called "contingent" component was uncertain only in terms of timing.

Description of MP2

The public financial markets began declining significantly in the spring of 2000. This decline took a severe toll on the asset base and financial status of SDCERS as well as other public pension funds. This decline, combined with the generous benefits granted under MPI, together with certain other related agreements, sent the SDCERS funded ratio into a freefall. By fall 2001, the 82.5 percent trigger had almost been reached. As the spring of 2002 approached, the City was involved in labor negotiations with four of the City's municipal labor unions. As before, the City viewed the labor negotiations, although not logically tied to the duties of the SDCERS Board, as a way to extract financial concessions from the Board.

In the meet and confer process with the labor unions, in order to again avoid paying an actuarially-determined contribution rate to the Retirement Fund, the City agreed to increase retirement benefits to an even greater degree than MPI had done. However, those increased benefits were explicitly contingent upon the SDCERS Board agreeing to a low contribution rate from the City. The proposed agreement between the City and SDCERS Board was reduced to writing in a document entitled "Agreement Regarding Employer Contributions Between the City of San Diego and the San Diego City Employees' Retirement System," commonly referred to as Manager's Proposal II [MPII].

Negotiations began with the City asking the Board to reduce the trigger 82.3 percent to 75 percent. In addition, the City wanted five years to increase payments to a full actuarial rate. The SDCERS actuary and outside fiduciary counsel both recommended against this first version of MPII. After further negotiation, the MPII agreement approved by the Board retained the existing 82.3 percent trigger. However, the City could keep paying so-called "contract rates," rather than the legally-required rates calculated by an actuary. The City agreed to increase its contribution rates 1.0 percent per year until 2008. MPII would then terminate in 2009.

The SDCERS' actuary observed that the Retirement Fund would be in better financial shape if the contributions were based on actuarial considerations. The actuary specifically noted that it would be preferable not to deviate from MPI:

> "From a pure actuarial viewpoint, it would be best to hold the City to the existing Managers Proposal [MPI] and the 82.3 percent trigger….[f]rom a pure actuarial viewpoint, we would prefer it if the Board <u>did not</u> provide a transition period to the City to reach the [full actuarial rate]."[21]

SDCERS' outside counsel also agreed with the assessment of the actuary, and warned at one point that a court could find that the Board was not exercising its fiduciary responsibilities, and could find individual Board members liable for their actions.[22]

Despite these direct warnings, the SDCERS Board and the City entered into MPII on November 18, 2002. The City also amended Municipal Code section 24.0801 so that the City would not be required to make contributions to the Retirement Fund as determined by an actuary (a requirement of §143 of the City Charter).

These resolutions and ordinances passed by the City Council were in return for the Board's agreement to permit under funding of the pension under MPII. Benefits granted by the Council under MPII included (1) increase in the "retirement factor" from 2.0 percent to 2.5 percent for general members, and as with MPI, retroactive through all years of service; (2) an exception from the 90 percent "retirement allowance cap" for employees who joined the City before their 24th birthday, which would directly benefit one Board member financially; (3) a so-

---

[21] Letter from SDCERS Actuary Rick Roeder to SDCERS Board, November 5, 2002; see also Vinson & Elkins Report, pp.82-86 (emphasis added).

[22] *See* Letter from *SDCERS'* counsel Robert Blum to Lawrence Grissom, SDCERS Plan Administrator, June 2002 (draft).

called “Presidential Benefit” whereby presidents of the City’s four recognized labor unions could have their salaries earned while serving as union presidents counted as though they were City salaries for the purposes of retirement; and (4) a City Council resolution (R-297335) specifically indemnifying the Board members for taking these actions. Again, as with MPI, the City induced the Board to abandon its logical and fiduciary duties, and made the delivery of these new benefits contingent upon the Board’s adoption of contribution rates below the actuarial amounts.[23] The payment avoidance scheme of 1996 was therefore repeated in 2002, with today’s nearly $1.5 billion funding deficit being the result.

Pension Reform Committee

In April 2001, the Mayor appointed a nine-member committee to examine the City’s fiscal health. One of the areas targeted was the City’s liability to its retirement system. Various City offices provided support to members of the Blue Ribbon Committee. The Committee issued its final report on September 15, 2004 (the report is posted on the City’s website). The report pointed out that easy choices in the present could lead to hard choices in the future:

> “The potential risk is that policy makers grant benefit enhancements today (to satisfy employee concerns, to negotiate trade-offs with unions, etc.), but avoid recognizing the actual annual cost of such by actuarially spread in the cost over years far out in the future, long after the individuals who made the policy decisions are gone.

The Pension Committee recommended that the City:

- fully fund the actuarially determined cost of the retirement system, including that of the healthcare benefit; and
- obtain a comprehensive analysis of projected pension and healthcare expenses to determine their impact on future City finances.

---

[23] Vinson & Elkins Report, pp.80-81.

The Pension Reform Committee also made a number of specific recommendations, including the following:

1. deposit $600 million in assets into SDCERS over the next three fiscal years, including no less than $200 million in fiscal year 2005 funded from pension obligation bonds;

2. require a period of no longer than 15 years for the amortization of losses; and

3. replace annually the amount equal to the contingent benefits paid from surplus undistributed earnings.

The pension reform committee's report received little attention, and brought about no immediate changes in policy. Moreover, the Committee's report was not considered at that time by the Rating Agencies in their evaluations of the City's financial status. It was not until a precipitate decline in SDCERS' funded ratio did the pension system's funding catch the attention of the rating agencies.

On October 5, 2004, the City Council of the City adopted a resolution which approved the first two of the Committee recommendations listed above. With respect to the third recommendation, the City Manager recommended that an actuarial cost analysis be prepared before the City Council approved such recommendation.

The Gleason Litigation

In January 2003, a putative class action complaint (*Gleason v. San Diego City Employees' Retirement System, et al.*) was filed in the San Diego Superior Court against the City and SCERS. The complaint alleged that from the Fiscal Year ended June 30, 1997, to the date of the filing of the litigation, the City did not contribute to SDCERS the annual amount required by certain provisions of the City Charter and the San Diego Municipal Code. The plaintiffs asserted that the City was contributing annual amounts to SDCERS based on two contracts (MP1 and MP2) that the City and SDCERS entered into in 1996 and 2002, respectively, and as a result of such actions, SDCERS was less than 68 percent funded and the UAAL was then $720 million, all in violation of the City Charter and Municipal Code provisions. (According to the SDCERS annual actuarial valuation, the funding ratio as of June 30, 2002 was 77.3 percent).

The City entered into a settlement agreement in August 2004 the Gleason litigation [2004 Agreement]. The 2004 Agreement (the provisions of which were followed in the preparation of the SDCERS 2004 Actuarial Valuation) provided that (i) the City would make a contribution of not less than $130 million for fiscal year 2005 (which would be $73 million less than the amount the Pension Reform Committee (as discussed below) determined was needed to keep the UAAL from increasing as a dollar amount), (ii) commencing with the June 30, 2004 Annual Actuarial Valuation, the UAAL amortization period would be reset to a new thirty-year fixed amortization period, (iii) for fiscal years 2006, 2007 and 2008, the City's contribution would be based on the actuarially required funding level based on the new thirty-year fixed amortization period, and (iv) after fiscal year 2008, subject to any amendment to the City Charter, the City would contribute at the actuarially required funding levels, based upon the amortization schedule chosen by the Board.

Actuarial Considerations

The California Supreme Court has determined that members of a governmental pension system have a right, under the California State Constitution, to an actuarially sound system. *Board of Administration v. Wilson* 52 Cal.App.4th 1109, 1131 (1997). SDCERS has been aggressive in its application of actuarial principles for at least twenty years. Certain members of the SDCERS Board reflect a bloc of City representatives. The net effect of many of such changes has been to reduce and/or defer City contributions to the system. These efforts have exacerbated simultaneous agreements by the City to its unions for enhanced benefit packages.

Effective June 30, 1991, SDCERS reset the amortization period for its UAAL (thus reducing the annual contributions) from the nine years remaining on the previous thirty-year period. The amortization period chosen by a system is largely elective provided it does not exceed thirty years. In the same year, SDCERS chose to switch from the entry age normal [EAN] funding system to the project unit credit [PUC] funding system. One characteristic of the PUC method is that it tends, especially in its early years, to lower the annual cost than the EAN method, and therefore results in lower actuarially employer required payments. By its adoption, the City reduced its actuarial accrued liability by approximately 2.8 percent. The PUC method is one of the funding methods specifically accepted by GASB. Although not as common as the EAN method, the PUC method is used by a number of municipalities. However, the PUC is not as conservative a funding method as the EAN.

The City's actuary worked with SDCERS to lower the effect of the pension funding problems on the City's financial statements. In 1998 the actuary suggested that SDCERS adopt a forty-year amortization period for purposes of *expensing* (and consequently reporting) its UAAL in contrast to the thirty-year amortization period used for calculating its annual contribution to

SDCERS. When it was determined that this approach could not be followed the actuary suggested an approach (the "Projected Unit Credit with forty-year amortization on a level percent of payroll basis") which had the effect of reducing the NPO by approximately $6 million. The City followed this format for every year from 1996 to 2002, and disclosed it only in January 2004. While this approach appears to be permitted under GASB, it was adopted for no other purpose than reducing the City's reported shortfall.

According to the Annual Actuarial Valuation of SDCERS dated as of January 14, 2005 (the "2004 Valuation"), prepared by Gabriel, Roeder, Smith & Company, the funded ratio (the valuation of assets available for benefits to total actuarial accrued liability) of the SDCERS fund as of June 30, 2004 was 65.8 percent, and the SDCERS fund had an unfunded actuarial accrued liability [UAAL] of $1.369 billion as of June 30, 2004. (As explained below, such liability could be significantly greater, estimated at approximately $1.59 billion as of June 30, 2004, using an alternative cost method.) Thus, for every dollar of benefits due (all vested liabilities), SDCERS had $0.658 in assets available for payment, if all vested benefits were due on June 30, 2004. As shown in Table 1 below, this represents the lowest funded ratio as of June 30 for any of the preceding ten fiscal years.

As stated previously, the UAAL is the difference between total actuarially accrued liabilities ($3.997 billion as of June 30, 2004) and actuarially calculated assets allocated to funding ($2.629 billion as of June 30, 2004).

Table 1 shows a 10-year history of the growth of the UAAL, and reflects a significant increase in the last few years:

Table 1
San Diego City Employees' Retirement System
Unfunded Actuarial Accrued Liability - Historic Comparison
($ in Thousands)

Valuation	**Valuation**	**Funded**	**Member**	**Ratio to**

Date	Assets	AAL[1]	Ratio	UAAL[2]	Payroll	Payroll
6/30/94	$1,216,063	$1,290,927	94.2%	$74,864	$338,440	22.1%
6/30/95	$1,316,903	$1,421,150	92.7%	$104,247	$350,584	29.7%
6/30/96[3]	$1,480,772	$1,620,373	91.4%	$139,602	$365,089	38.2%
6/30/97	$1,632,361	$1,748,868	93.3%	$116,507	$382,715	30.4%
6/30/98[4]	$1,852,151	$1,979,668	93.6%	$127,517	$399,035	32.0%
6/30/99	$2,033,153	$2,181,547	93.2%	$148,394	$424,516	35.0%
6/30/00	$2,459,815	$2,343,400	105.0%	($116,414)	$448,502	(26.0)%
6/30/00[5]	$2,459,815	$2,528,774	97.3%	$68,959	$448,502	15.4%
6/30/01	$2,525,645	$2,809,538	89.9%	$283,893	$481,864	58.9%
6/30/02	$2,448,208	$3,168,921	77.3%	$720,713	$535,157	134.7%
6/30/03	$2,375,431	$3,484,832	68.2%	$1,109,401	$533,595	207.9%
6/30/03[6]	$2,375,431	$3,532,626	67.2%	$1,157,194	$533,595	216.9%
6/30/04[7]	$2,628,680	$3,997,328	65.8%	$1,368,648	$540,181	253.4%

1. AAL: Actuarial Accrued Liability.
2. UAAL: Unfunded Actuarial Accrued Liability (Valuation Assets – AAL).
3. Reflects the implementation of the 1996 settlement agreement referred to herein.
4. Reflects revised actuarial and economic assumptions.
5. Includes increases for Corbett non-contingent benefits. See “Supplemental and Contingent Payments by SDCERS.”
6. Includes changes in benefits for general members.
7. Reflects revised actuarial assumptions.

Source: 2004 Valuation

As the result of corresponding agreements between the City and SDCERS, and collective bargaining agreements between the City and its employee unions, entered into in 1996 and 2002[24], and the 2004 Agreement (defined below), the City has been paying less than the amount needed to fully fund the pension system. This is one of the principal factors that has caused the significant under-funding of the pension system, and, in the opinion of the current City Attorney, was in violation of the City Charter.[25]

In light of the City’s unfunded pension liability, if the City were to make a contribution in a particular year that would begin to amortize the UAAL, it would consist of: (i) the “normal cost,” being the present value of the benefits that SDCERS expects to become payable in the

24 See *Interim Report No. 3 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials*, Report of the San Diego City Attorney Michael J. Aguirre (Apr. 8, 2005), for a description of the 1996 and 2002 agreements.

25 *Interim Report No. 2 Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials*, Report of the San Diego City Attorney Michael J. Aguirre (Feb. 9, 2005), text accompanying footnote 9.

future attributable to a current year's employment, and (ii) payments, if any, made to amortize the UAAL.

The City has been paying significantly less than such contribution levels. With respect to the fiscal year 2004 contribution, the 2004 Valuation states that "the interest on the unfunded liability of $91 million exceed[ed] the City contributions of $19 million to pay down the unfunded liability." In addition, the 2004 Valuation advised that the actual contribution for fiscal year 2004 was $68.6 million less than the actuarially required contribution for such year as computed in the prior year's actuarial valuation.

The validity of an actuarial valuation is dependent upon the reasonableness of the numerous assumptions that underpin the analysis, including investment return rate, inflation rate, rates of mortality, etc. In addition to the assumptions made, the actuary may utilize different amortization periods and different amortization methods in amortizing any accrued unfunded liability. SDCERS engaged Mercer Human Resource Consulting [Mercer], an independent actuarial consulting firm, to audit the 2003 Valuation and to identify any changes in assumptions or methods that would improve the quality of the actuarial valuation. In addition, Towers Perrin, another independent actuarial consulting firm, was engaged by the City to review the 2002 Valuation and determine "if the unfunded liabilities already reported and projected into the future were reasonable representations of expected results." Each report contained a number of recommendations regarding the assumptions used in preparing the actuarial valuations, and each report also suggested the use of an alternative cost method. The pension system's actuarial valuations have historically used the Projected Unit Credit [PUC] cost method to develop the funded ratio and contribution rates. Under PUC, an actuarial accrued liability (liability for service already worked in prior years) and a normal cost (additional liability for service worked during the current year) are developed. The actuarial accrued liability is compared to the actuarial value of assets to develop the UAAL and the funded ratio (See Table 1).

Mercer advised that the PUC method tends to push more costs into the later part of a member's service. Mercer recommended the use of the Entry Age Normal [EAN] cost method as more suitable if SDCERS desires to maintain a stable normal cost as a percent of payroll. Similarly, Towers Perrin advised that the EAN method is used by approximately three-quarters of public sector funds. In addition, an agreement entered into by the City and SDCERS in 2002, which was superseded by the 2004 Agreement, provided that the "City and the Board agree that the Board will take all necessary and appropriate actions, starting with determining the City's contribution rates beginning on July 1, 2009, to rapidly bring the City's contributions to SDCERS to the contribution rates determined under the entry age normal funding method."

The EAN method develops a level contribution as a percent of pay (normal cost), which if contributed and invested throughout the member's career is expected to generate sufficient funds to equal the actuarial value of the future benefits payable by the time the member retires. In order to keep the costs level, a larger normal cost is allocated for the earlier years and a relatively smaller normal cost is allocated in the later years compared to the PUC method. The funded ratio of 65.8 percent for the June 30, 2004, valuation date is based upon the PUC method. If the EAN method were utilized, the 2004 Valuation indicated that the funded ratio for the June 30, 2004 valuation date would be 62.3 percent, which corresponds to an UAAL of approximately $1.59 billion.[26]

Facts Concerning the City's Wastewater Rate Structure

---

26 See Table 1. Valuation Assets of $2,628,680,000/.623 = $4,219,390,000 (AAL). Valuation Assets - AAL = $1,590,710,000.

The City provides wastewater treatment for the Municipal System, which consists of a municipal sewer collection system for City residents ("retail" users) and the Metropolitan System, which is a regional sewage collection, treatment and disposal system serving Participating Agency users ("wholesale" users). The Wastewater System is owned and operated by the City under the administration of the Metropolitan Wastewater Department of the city [MWWD]. The Metropolitan System provides sewage transportation, treatment and disposal services to more than 2 million residents within a regional service area which encompasses the City and fifteen Participating Agencies (eight cities and seven districts). The Municipal System provides sewage collection with in the City and Consists of over 2,950 miles of trunk and collector mains, eighty-two sewer pump stations and sixteen stormwater interceptor pumping stations serving in excess of 260,000 customer accounts. The communities and agencies served by the Wastewater System form the second largest integrated metropolitan area in the State of California surpassed only by the Los Angeles metropolitan area.

The Federal Clean Water Act (33 U.S.C.A. section 1251, *et seq*.) specifically authorizes the State Water Resources Control Board [SWRB] to enter into contracts with municipalities and other public entities for financial assistance for the construction of publicly owned treatment works. During 1989, the City began entering into contracts with the U.S. Environmental Protection Agency and the SWRB and has received approximately $370 million in Federal Clean Water grants, and State low interest loans, called State Revolving Fund loans [SRF Loans]. Both the Federal grant program and the State loan programs required, as a condition of receiving financial assistance that the City put in place a user charge system under which each user pays its proportionate share, based on the costs attributable to each user. (See section 35.929.2 of EPA Regulations and section 17 of the SRF Loan Contract.)

On November 5, 1998, California voters of the State approved Proposition 218, the Right to Vote on Taxes Act. Proposition 218 added Articles XIIIC and XIIID to the California Constitution, contains a number of provisions affecting the ability of local governments, such as the City, to levy and collect both existing and future taxes, assessments, fees, and charges. Among its several provisions, Proposition 218 requires that revenues derived from the fee or charge may not exceed the funds required to provide the property-related service. Moreover, the amount of a fee or charge imposed upon any parcel or person as an incident of property ownership must not exceed the proportionate cost of service attributable to the parcel.

Over several years several efforts were made to obtain City Council approval of a rate structure that would be approved by the SWRCB. In 1998, the City entered into an agreement with the wholesale users (Participating Agencies) to identify and add a third cost component, "organics," for the purpose of calculating sewer bills, and this rate structure was approved by the SWRCB. However the City did not implement measure to bring its retail rate structure into compliance with federal and State requirements.

In a letter dated November 26, 2003, the SWRBC indicated that it did not have a record of the approval of the Municipal system's user rate structure and requested that the City produce such evidence. On March 17, 2004, the SWRBC reiterated its request that the City produce evidence that the City adopted a compliant Municipal sewer rate structure. In this letter the SWRBC gave the City a specific time frame to have such rate structure in place. Failure by the City to adopt a SWRBC rate structure risked forfeiture of previously received Clean Water Grants and the accelerated maturity of State low interest loans. The potential exposure to the City was approximately $266 million. In June 2004 the City added an organic cost component to its formula for calculating its Municipal sewer customer's bills (retail).

In June 2004, a class action lawsuit was filed seeking a refund for single-family residents. *Shames v. City of San Diego* alleges that because the City failed until 2004 to factor the cost of organics in its billing formula, single family users were paying more than their proportional cost of service, while some commercial/industrial users were paying less than their proportional cost of service. The lawsuit asserts two causes of action. The first alleges that in violation of the California State Constitution California Constitution Article XIII D section 6(b)(3) (Proposition 218), the City failed to require that City sewer fees, "imposed on any parcel or person as an incident of property ownership," not exceed "the proportional cost of the service attributable to the parcel." Plaintiffs allege that the City had never complied with Proposition 218 because the proportional cost of removing organics from the effluent was not included in the municipal user's billing formula. Moreover, Plaintiff contends that the City's agreement to factor the cost of removing organics in the bills of wholesale sewer payers demonstrates the lack of proportionality in the retail sewer billings.

Plaintiffs' second cause of action for breach of contract rests upon contractual language in the Environmental Protection Agency's grants and State of California loans that the City obtained to facilitate its sewer infrastructure. The Environmental Protection Agency's grants require compliance with the Code of Federal Regulations, which references a proportional cost of service requirement in the grantee's billing methodology with State mandates. California's Water Resources Control Board oversees the loan contracts and EPA grants and must approve the revenue plan that they demand. In order to fulfill this oversight obligation, the State publishes Revenue Program Guidelines. With respect to rate determination these guidelines specify that, *"First, cost is allocated among* the *treatment parameters (flow, BOD, TTS and other appropriate constituents) in proportion to the percentage of cost that these parameters represent*."

Accordingly, Plaintiff alleges that the class (single family residences) is the third party beneficiary of these grants and loans. Plaintiff then alleges that the lack of proportionality and the failure to specifically incorporate organics in the billing formula are breaches of the contracts for the grants and loans.

Currently, the City and Plaintiffs are discussing remedial measures that will ensure future periodic review of sewer costs of service and in turn, of sewer billing formulas. Also contemplated are refunds for this class of single-family residents. This litigation and related discussions thereto are before both the Court and before a retired federal magistrate acting as a mediator at the request of the parties.

Disclosure of Pension System Under Funding from 1996 to 2003

This report involves the following disclosures by the City of San Diego:

1996 Disclosures

Bond Offerings

1. $73,500,000 City of San Diego, California 1996-97 Tax Anticipation Notes Series A

2. $33,430,000 City of San Diego, California Certificates of Participation (Balboa Park and Mission Bay Park Capital Improvement Program) Series 1996A. The disclosure relating to the pension system was substantively unchanged from the Official Statement of June 5, 1996.

3. $11,750,000 City of San Diego, California Certificates of Participation (Balboa Park and Mission Bay Park Capital Improvement Program) Series 1996 B. The disclosure relating to the pension system was unchanged from that contained in the July 16, 1006 Official Statement.

4. $68,425,000 Public Facilities Financing Authority of the City of San Diego Taxable Lease Revenue Bonds Series 1996A (San Diego Jack Murphy Stadium.

1997 Disclosures

Bond Offerings

1. $82,000,000 City of San Diego, California 1997-98 Tax Anticipation Notes Series A.

Annual Reports

1. Continuing Disclosure Certificate (Taxable Lease Revenue Bonds, Series 1996A).

2. Continuing Disclosure Certificate (Series 1996B Refunding Certificate of Participation).

3. The City CAFR for FY 1996.

1998 Disclosures

Bond Offerings

1. $88,500,000 City of San Diego, California 1998-99 Tax Anticipation Notes Series A.

2. $205,000,000 Convention Center Expansion Facilities Authority Lease Revenue Bonds Series 1998A (City of San Diego, California, as Lessee).

Annual Reports

1. Continuing Disclosure Certificate (Series 1996B Refunding Certificates of Participation.

2. Continuing Disclosure Certificate (Series 1996A Refunding Certificates of Participation.

3. Continuing Disclosure Certificate Taxable Lease Revenue Bonds Series 1996A

4. City CAFR for FY 1997.

1999 Disclosures

Bond Offerings

1. $99,500,000 City of San Diego, California 1999-00 Tax Anticipation Notes Series A.

Annual Reports

1. Continuing Disclosure Certificate (Certificates of Participation 1996A).

2. Continuing Disclosure Certificate (1996B Refunding Certificates of Participation.

3. Continuing Disclosure Certificate (Taxable Lease Revenue Bonds Series 1996A).

4. Convention Center Expansion Authority Lease Revenue Bonds, Series 1998A.

5. City CAFR for FY 1998.

2000 Disclosures

Bond Offerings

1. $53,000,000 City of San Diego, California 2000-01 Tax Anticipation Notes Series A.

2. $24,000,000 City of San Diego, California 2000-01 Tax Anticipation Notes Series B.

Annual Reports

1. Continuing Disclosure Certificate (Certificate of Participation Series 1996A).

2. Continuing Disclosure Certificate (Refunding Certificate of Participation, Series 1996B).

3. Continuing Disclosure Certificate (Taxable Lease Revenue Bonds, Series 1996A).

4. Continuing Disclosure Certificate (Convention Center Expansion Financing Authority Lease Revenue Bonds, Series 1998A).

5. City CAFR for FY 1999.

2001 Disclosures

Bond Offerings

1. $73,000,000 City of San Diego, California 2001-02 Tax Anticipation Notes Series A.

Annual Reports

1. Continuing Disclosure Certificate (Certificate of Participation Series 1996A).

2. Continuing Disclosure Certificate (Refunding Certificate of Participation, Series 1996B).

3. Continuing Disclosure Certificate (Taxable Lease Revenue Bonds, Series 1996A).

4. City CAFR for FY 2000.

2002 Disclosures

Bond Offerings

1. $169,685,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds Series 2002 (Ballpark).

2. $93,200,000 City of San Diego, California 2002-03 Tax Anticipation Notes Series A. The Disclosure for this offering repeated the pension information that was disclosed in connection with the issuance of the Public Facilities Financing Authority Lease Revenue Bonds Series 2002 on February 14, 2002, and in the Annual Reports filed April 9, 2002.

3. $25,070,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds Series 2002B (Fire and Safety Project).

Annual Reports

1. Continuing Disclosure Certificate (Certificate of Participation Series 1996A).

2. Continuing Disclosure Certificate (Refunding Certificate of Participation, Series 1996B).

3. Continuing Disclosure Certificate (Taxable Lease Revenue Bonds, Series 1996A).

4. City CAFR for FY 2001.

<u>1997-2003 City Financial Information</u>

The City's financial information was generally contained in an appendix [Appendix A] to the disclosure documents, and covered many of the significant financial policies of the City. For purposes of these proceedings, particular attention will be paid to City disclosures regarding its labor policies and pension system funding. Also attached to the City's official statements were portions of the City's financial statements. The information contained in these appendices should have contained all relevant information necessary for investors to evaluate the City's financial health, including the City's general fund's financial strength relative to the increasing pension and other costs.

City Disclosure Documents Contained False or Misleading Information or Omitted Material Information Regarding MP1 That Rendered Such Disclosure Documents Materially Misleading

Under the City heading "Fiscal Year 1997 Proposed Budget," Appendix A contained a discussion of the Fiscal Year 1997 Proposed Budget. While City officials were implementing MPI, which contemplated a reduced payment to SDCERS, no discussion of MP1, including the "offset" to the City contribution to be derived from undistributed surplus earnings, was discussed in Appendix A or elsewhere in the City's official statements for the period 1996 through 2002, although MP1 was reflected in footnote 9.b. *Funding Policy of the Notes to Financial Statements of the City's General Purpose Financial Statements*. MP1 was rendered in its final form on July 23, 1996.

None of the City's offering documents, or annual reports, over the relevant period (beginning in 1997 and extending into 2003) disclosed the nature of the risk that the rate relief embodied by MP1 presented. It was estimated by the SDCERS actuary that MP1 would absorb approximately $110 million in existing surplus earnings in the pension fund. As well, none of the City disclosure documents discuss the financial risk to the City's budget if the funded ratio of the pension system fell below 82.3 percent (the so called MP1 trigger). However the SDCERS actuary believed that the trigger would be hit within 5 or 6 years, and that such event would subject the City to either a significant lump sum payment or substantially higher annual payments until the 82.3% floor was reached. The trigger provision is described in the City disclosure documents in terms that made it appear as a safeguard but it did not adequately advise investors of the potential serious financial adverse impact to City finances of a significant lump-sum payment, or alternatively, of the potential adverse impacts of significantly increased pension system payments. Finally, none of the City disclosure over the relevant period disclosed that the actuarial assumptions and benefit levels would change significantly over the life of MP1 but that such changes would not be reflected in City annual pension contributions. Accurate information about MP1 and its risks to City finances would have been material to investors as it would have shed light on potential risks to City finances given the assumptions underlying payments to SDCERS and the costs of enhanced retirement benefits, and the failure to describe accurately MP1 and the implications for City finances rendered said official statements and annual reports for the relevant time frame materially misleading.

Under the heading "Labor Relations," Appendix A provides information on negotiated salary increases with the labor organizations that cover a substantial majority of City employees. However the section is silent as to negotiated increases in benefits for employees that increase the "pension benefit obligation" or overall value of future benefits to be paid out of SDCERS, which would require funding from some source but the source is not identified. In fact, the City charter was amended in November 1996 to provide post-retirement health insurance as a pension benefit. But the official statements are silent as to the future costs of such benefits or from what source the contributions were likely to be derived. A reasonable investor would have wanted information about the benefit improvements contained in MP1 and the costs of such improvements and since the official statements for the period 1996 through 2003 failed to disclose this information and the lack of this information rendered the City's official statements materially misleading.

Appendix A also included information about the City's pension funding scheme. The format was followed in each of the official statements over the period 1996 through 2003. The last of the three paragraphs would be updated from time to time to reflect results of recent financial information:

> "All City full-time employees participate with the full-time employees of the San Diego Unified Port District in the City Employee's Retirement System [CERS]. CERS is a multiple-employer public employee retirement system that acts as a common investment and administrative

> agenda for the City and the District. Through various benefit plans, CERS provides retirement benefits to all general and safety (police and fire) members.
>
> The CERS plans are structured as defined benefit plans in which benefits are based on salary, length of service and age. City employees are required to contribute a percentage of their annual salary to CERS State legislation requires the City to Contribute to CERS at rates determined by actuarial valuations.
>
> The City's last annual valuation dated June 30, 1995, stated the funding ratio (Net Assets at cost available for Benefits to Pension Benefits Obligation) of the CERS fund to be 86.8 percent. The CERS fund has an Unfunded Actuarial Accrued Liability [UAAL] of $96.3 million as of June 30, 2005. The UAAL is the difference between total accrued liabilities of $1.477 billion and actuarially valued assets allocated to funding of $1.380 billion. The UAAL is amortized over a thirty-year period which started July 1, 1991, with each year's amortization payment reflected as a portion of the percentage of payroll representing thee employer's contribution rate. As of June 30, 1995, there were twenty-six years remaining in the amortization period. As there are some on-going meet and confer items being discussed, the June 30, 1995, actuarial report has not been ratified by the Retirement Board but is expected to be ratified in the near future." [CERS is herein referred to as SDCERS]

The information about the City's pension system should provide investors with a general structure of the pension system and its overall financial impact on the City's finances. The pension disclosure was materially misleading because it failed to describe significant funding practices and the potential long-term impact that theses policies could have on the financial health of the pension system, and correspondingly on City finances. The 1997 CAFR failed to describe the changes in funding policies resulting from MP1, and specifically that the City ceased contributing to SDCERS on an actuarially determined basis, having substituted the contractual rates of MP1. While the 1997 CAFR showed a net pension obligation of $5.975 million for 1997, Note 9 to the City's financial statements indicates that "[t]here is no Net Pension Obligation at year end as Actuarially Required Contributions and Contributions Made have always been identical during [fiscal years 1995 through 1997]." It was estimated by the

SDCERS actuary that MP1 (with pension enhancements) would absorb approximately $110 million of surplus system earnings, although the SDCERS actuary believed that this would not compromise the financial soundness of the pension system. Nonetheless, the general pension disclosure omits a significant funding policy, the use of “undistributed surplus earnings” to fund the so called 13th check and other contingent benefits of the system. This practice had a significant impact on the ability of the pension system to withstand a significant downturn in market investment returns.

The City included in its Appendix B “General Purpose Financial Statements” which were to have included “Pension Trust Funds Analysis of Funding Progress, Revenue Sources, Expenses By Type---Last Ten Years,” as recommended by the Governmental Accounting Standards Board. Finally, the City’s bond offerings included the statement: “State legislation requires the City to contribute to SDCERS at rates determined by actuarial valuation.” The City and its outside professionals could not substantiate this statement, and moreover this statement was materially at odds with City practices with respect to funding it pension system. This information was not included in any of the official statements over the period [1996 through 2002]. The official statements over the relevant period [1996-2002] do not describe all the material facts that would be relevant to investors and so rendered the City’s official statements materially misleading.

The City’s Disclosure Documents Omitted Certain Material Information about the Corbett Litigation That Rendered Such Disclosure Documents Materially Misleading

In July 1998 the City’s Employee’s Retirement System was sued by four retirees (the Corbett litigation) challenging the method by which their retirement pay was calculated. The matter was subsequently certified as a class action, joining all active and eligible retired City employees. The City entered into mediation with the class employees and a settlement was reached in May 2000. The results of the settlement committed surplus earnings to increase payments to retirees, as well as increasing benefits for future retirees thereby increasing the pension system's total liabilities. The official statements beginning with the issuance of the $205,000,000 Convention Center Expansion Facilities Authority Lease Revenue Bonds Series 1998A to the April 5, 2000, Annual Reports do not mention the Corbett litigation or the exposure to the City if the Corbett litigation was determined adverse to the City. The Corbett litigation would have been relevant to investors in the City bonds as it would have indicated current and future additional costs with respect to the City's pension system, and the failure to include such information rendered the City's official statements over this period materially misleading.

The City's 2002 Disclosure Documents Omitted Certain Material Information and Contained Materially Misleading Information About its Pension Fund

On February 12, 2002 the retirement actuary issued its report for fiscal year 2001, which reflected an experience loss of $193.2 million. The report indicated that half of the loss could be attributed to investment losses, and indicated that investment losses would be larger in subsequent years without significant improvements in investment earnings. Also the report indicated that the City's funding practices for the retirement system would foster additional declines in the funded ratio in the absence of healthier investment returns. On February 14, 2002, the City issued $169,685,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds Series 2002 [Ballpark Bonds], on June 4, 2002, the City issued $93,200,000 of its Tax and Revenue Anticipation Notes Series A [2002 TRANS], and on June 12, 2002 the City issued $25,070,000 Public Facilities Financing Authority of the City of San Diego Lease Revenue Bonds Series 2002B (Fire and Safety Project) "Fire and Safety Bonds"). The discussion of the financial condition of the pension system was substantially the same in each of the financings. In each case, the offering documents contained two year old information about the funding of the retirement system dated as of June 30, 2000, which showed a funded ratio of 97 percent. However a draft valuation report had been circulated within the City by no later than February 12, 2002, showing that the funded ratio had declined to approximately 89.9 percent. While it is unclear how far this report was disseminated throughout the City, it is clear that City officials who were participating in the financing knew or should have know that the pension system funding level was under stress. It is clear that individuals within the Treasure's office knew that it was likely or probable that the MP1 trigger could be hit by the end of the fiscal year, which under one interpretation of the relevant provisions would have required the City to make a substantial payment to the City retirement system. The City was under no obligation under GASB to disclose forward-looking information and at the time GASB did not, specifically, require governmental issuers to estimate and disclose projected costs of healthcare benefits---a potentially large component of the City's pension system---the failure to do so rendered the City's public disclosures during Fiscal 2002 materially misleading. Under the securities laws, issuers are required to provide the market information that, taken as a whole, represents a fair and accurate picture of the issuer's financial situation. It suffices to say that that the City's 2002 disclosure did not accurately disclose certain risks to the City's pension system that would be material to a reasonable investor.

The SEC has previously taken the position that a municipal issuer is required to disclose information concerning material financial reversals, even if they cannot be estimated with precision. In the order relating to the Massachusetts Turnpike, the SEC stated:

> "At the time of these offerings, the project staff had projected cost increases exceeding $1 billion, which should have been disclosed to the public, including bondholders, underwriters, and credit rating agencies in connection with the bond offerings. However, because the cost increases had not been fully quantified or confirmed, the Respondents deemed them to be speculative and did not disclose them. Instead, beginning in

> the spring of 1999, the Project staff embarked upon an effort to quantify and confirm the specific amount of any cost increases, including a "bottom-up" review of every Project contract . . . their failure to disclose such cost increases did not take into account their obligations under the federal securities laws. By their negligent conduct, the Turnpike Authority committed . . . violations of section 17(a)(2) and (3) of the Securities Act. [Massachusetts Turnpike Authority, Securities Act Rel. No. 8260 __, 361.]"

The City was under no legal obligation to disseminate the contents of the Blue Ribbon Committee Report, or to include the contents of the Committee's report in any City disclosure. Nonetheless, to the extent that the Report cast doubt upon or raised questions about City pension information City officials were under a duty to make further inquiry and amend City disclosure if necessary.

Yet none of this was disclosed in any of the City's 2002 disclosure documents. The information about the pension system was also not included in the City's 2002 CAFR in the face of the statement that "All disclosure necessary to enable the reader to gain an understanding of the City's and its related entities financial activities have been included." The information about the funding level of the pension system and its recent investment experience would have been material to a reasonable investor, and the failure to provide such information rendered the City's 2002 disclosures material misleading.

The City Omitted Material Information and Provided Misleading Information For Its 2003 Offering Documents and other Disclosures.

In 2003 the City issued its $15,260,000 San Diego Old Town Light Rail Transit Extension Refunding Bonds, its $17,400,000 1993 Balboa Park/Mission Bay Park Refunding Bonds, and its $110,900,000 2003-2004 Tax and Revenue Anticipation Notes. While the City disclosure documents contained information reflecting an increase in the UAAL from $436.8 to $720.7 million, and showed statistics showing the effect of increased pay but not retirement benefits for its two labor unions. The City disclosure documents do not explain to investors the drivers behind the dramatic change in the UAAL. As well, the disclosure documents make no mention of the adoption of MP2, the financial challenges sought to be addressed by such proposal, and the resulting financial challenges to the City's general fund. Also, the City's 2003 disclosures fail to discuss that City officials were aware that pension system liabilities were expected to grow substantially over the ensuing years, and by some estimates were expected to be more than $2 billion. A reasonable investor would have deemed this information important and the failure to provide such information rendered the City's disclosure documents materially misleading.

City Wastewater Disclosures Omitted Information Regarding Requirements Pertaining to its Rate Structure as such Was Materially Misleading

In March 1997 the City caused to be issued its $250,000,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1997A and Series 1997B [the "1999 Bonds"], and in March 1999 the City caused to be issued its $315,410,000 Public Facilities Financing Authority of the City of San Diego Sewer Revenue Bonds, Series 1999A and Series 1999B [the "1999 Bonds" and collectively, the "Sewer Bonds"]. Proceeds of the 1997 Bonds were applied to the acquisition of capital improvements for the Metropolitan System, while proceeds of the 1999 Bonds were applied to finance, among other things, capital improvements for the Municipal and the Metropolitan Wastewater Systems.

The official statements for the Sewer Bonds, among other pertinent information, contains information regarding the regulatory requirements pertaining to the receipt of federal and State grants and loans. Under the caption "Wastewater System Regulatory Requirements" the City indicates that "[a]s a condition of its past receipt of federal grants, the State Board, as delegate of the EPA, must approve the sewer service charge structures of the City and the Participating Agencies." The City further states that "[t]he City's rate structure has been reviewed by the

State Board and not grant funds or costs under grant funded programs have been disallowed on the nature of the rate structures."

In another part of the City's Sewer Bond official statements the City discusses the impact of Proposition 218 on the City's rate structure. Under the caption "Impact of Proposition 218 on Sewer Rates and Charges" the City lists the substantive requirements that apply to all property related fees and charges. Under subparagraph (3) it provides that "the amount of a fee or charge imposed upon any parcel or person as an incident of property ownership must not exceed the proportional cost of the service attributable to the parcel."

There was, and continues to be, some dispute regarding whether Proposition 218 applies to volumetric fees and charges such as the City's wastewater fees, and no concession was made by the City on this point. However the City does indicate that it believes that its rates and charges comply with the substantive provisions of Proposition 218.

The City was a participant in the Federal Clean Water Grant program, and had been a participant since the early 1970's. The City was also a participant in the State's Revolving low-interest loan [SRF] program. The City had received a total of 17 separate federal and State Clean Water grants, and eight SRF loans since the program's inception, constituting several hundred million dollars. As a condition of receiving the Clean Water Grants and as a covenant in the SRF loan agreements, the City was required to implement and maintain an approved wastewater user charge system that met certain proportionality requirements. The City received two letters from the State Water Resources Control Board [SWRCB], which, collectively, required the City to provide evidence that the City had implemented a compliant retail user charge system. The City did not disclose in either the 1997 or 1999 offerings that it did not have a compliant retail rate structure and as such faced the potential forfeiture of State loans and grants in the hundreds of millions of dollars, and the failure to render such information made the City's disclosures with respect to its Sewer Bonds was materially misleading. Moreover the City affirmatively asserted that its rate structure complied with Proposition 218 when officials within the City knew or should have known that this was not the case, and such affirmative representation rendered the City's disclosure materially misleading to investors in the City's Sewer Bonds.

Legal Analysis: the City violated the Antifraud Provisions of the Securities Act and the Exchange Act in the offer and sale of the Municipal Securities

We have reviewed the City's disclosure documents from 1996 to date relating to the offer and sale of City securities, as well as extensive documentation provided by the City and City officials either voluntarily or pursuant to subpoena. In addition, we have reviewed (i) the First V&E Report, (ii) the Second V&E Report, and (iii) the six Interim Reports Regarding Possible Abuse, Illegal Acts or Fraud by City of San Diego Officials prepared by the City of San Diego Office of the City Attorney.

As described more fully above, since 1996, in the offer and sale by the City of securities secured by the City's General Fund, the City has "failed to provide investors and other interested readers with adequate information to enable them to clearly understand the relationship between SDCERS and the City's General Fund and to fully evaluate the creditworthiness of the City."[27]

Information is material if there is a substantial likelihood that a reasonable investor would consider it important to making an investment decision. See *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Furthermore, when the information pertains to a possible future event, "materiality 'will depend upon a balancing of both the indicated probability that the event will occur and the anticipated

[27] [Second V&E Report]

magnitude of the event in light of the totality of the company activity.'" *Basic Inc.*, 485 U.S. at 238 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969)).

Scienter is required to establish violations of section 17(a)(1) of the Securities Act and section 10(b) of the Exchange Act and Rule 10b-5 thereunder; negligence is sufficient to establish a violation of section 17(a)(2) or 17(a)(3). See *Aaron v. SEC*, 446 U.S. 680, 701-02 (1980). Scienter is "a mental state embracing intent to deceive, manipulate or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). In the Ninth Circuit, recklessness satisfies the scienter requirement. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) (en banc), cert. denied, 499 U.S. 976 (1991). Recklessness is "an extreme departure from the standards of ordinary care, and which presents a danger of misleading [investors] that is either known to the defendant or is so obvious that the actor must have been aware of it." Id., 914 F.2d at 1569.

The V&E Reports and the City Attorney's reports both conclude that the City's disclosures regarding its pension system contained material misstatements and omissions. Those reports differ to some degree regarding the relative degrees of culpability of the Mayor, the City Council, and various City officials and employees. But regardless of the ultimate findings made by the Commission regarding the negligence, recklessness, or intentional misconduct of City officials, for purposes of the City's liability under the federal securities laws, the negligence, recklessness, or intentional misconduct of City officials may be imputed to the City. See *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1089 n.3 (2d Cir. 1972); SEC Initial Decisions Rel. No. 185 (June 22, 2001) (*In the matter of the City of Miami, Florida, Cesar Odio and Manohar Surana*).

The notes and bonds issued by the City are clearly securities under section 2(1) of the Securities Act and section 3(a)(10) of the Exchange Act.

Remediation Measures

The City has undertaken significant and unprecedented remedial measures in response to the deficiencies in its disclosure practices.

Voluntary Filings. The City, upon learning of certain errors in official statements relating to the disclosure of the pension underfunding and other miscellaneous matters, made voluntary filings with the nationally recognized municipal securities information repositories on January 27, 2004, and again on March 12, 2004. The City had entered into various continuing disclosure agreements in order to assist compliance by underwriters with Rule 15c2-12 under the Securities Exchange Act of 1934, in which the City agreed to certain specified annual disclosure and to disclose certain specified events, if determined by the City to be material. The voluntary filings were not required pursuant to such continuing disclosure agreements. Such disclosures may have been required under the federal securities laws to the extent such disclosures were correcting disclosures that were materially misleading or incorrect when made.

Investigative Counsel. Upon learning of the disclosure concerns that resulted in the voluntary filings, the City hired V&E to conduct a thorough review of the City's disclosure practices from 1996-2004 relating principally to the pension system.

Disclosure Ordinance. The City, at the suggestion of V&E, adopted a disclosure ordinance (O-19320) on October 11, 2004 [Disclosure Ordinance]. The Disclosure Ordinance was intended to address the concerns raised by the First V&E Report. The Disclosure Ordinance is patterned after the reforms instituted by the Sarbanes-Oxley Act. The Disclosure Ordinance (1) establishes a Disclosure Practices Working Group, comprised of the City Attorney, the Deputy

City Attorney for Finance and Disclosure, the City Auditor and Comptroller, the City Treasurer, the Deputy City Manager for Finance, the City's outside general disclosure counsel, and such other persons as such City officials appoint, to review "the form and content of all of the City's documents and materials prepared, issued, or distributed in connection with the City's disclosure obligations relating to its securities" and "disclosures provided by the City in connection with securities issued by the related entities"; (2) requires the City Manager and City Attorney to personally certify to the City Council regarding the accuracy of Official Statements; and (3) requires the Disclosure Practices Working Group to conduct a thorough review of the City's disclosure practices and to recommend disclosure controls and procedures.

The City represents that the Disclosure Practices Working Group has been meeting on a regular basis, and is currently in the process of adopting disclosure controls and procedures.

Outside Disclosure Counsel. The First V&E Report raised the concern that the City, by the use of multiple disclosure counsel, was not well served because there was a tendency of staff to "shop" disclosure approaches and because no one disclosure counsel was responsible for assuring the uniformity and accuracy of the City's disclosures. The City accepted the recommendation of that report, and has engaged Hawkins Delafield & Wood LLP [Hawkins] to serve as its outside disclosure counsel. The City has advised that Hawkins has conducted various seminars for City employees to advise them of their responsibilities under the federal securities laws, and that a representative of Hawkins is a member of the Disclosure Practices Working Group.

New Auditors. Although the City's prior auditors had completed their audit of the City's fiscal year 2003 general financial statements, in light of certain errors discovered concerning the City's fiscal year 2002 general financial statements, which were the subject of voluntary disclosure filings by the City, the City engaged KPMG to conduct a full scope audit of the City's fiscal year 2003 general financial statements. That audit by KPMG is continuing.

Audit Committee. The City has established an independent Audit Committee, consisting of persons who are not City employees, to review the reports of V&E and of the City Attorney, and to assist KPMG in its consideration of AU 317.

Waiver of Attorney-Client Privilege. The City has provided the Commission with all documents requested pursuant to the various subpoenas, and in doing so has waived its attorney-client privilege.

Remediation. The following persons (without any intention in this Order to assign any degree of culpability) have either resigned, voluntarily terminated their employment with the City, or have been fired by the City: the former Mayor; the former City Manager; the current City Manager (who resignation is effective December 31, 2005); the former City Auditor and Comptroller; the former Deputy City Auditor and Comptroller; the former Treasurer; the former Deputy City Manager for Finance; [Herring, Lexin, others]

Conclusion

The Commission finds that the City's disclosures regarding the funding of its pension system and its wastewater rate structure contained material misstatements and omissions. Various City officials and employees were either negligent, reckless, or intentionally created or permitted material misstatements or omissions, and the City is responsible and culpable for the actions of such persons. Nevertheless, in light of the significant remediation measures described above and the cooperation afforded the Commission staff, and the severe financial hardship being imposed upon the City as the result of the continuing delay in the release of the report of the Audit Committee and the audit letter of KPMG, the Commission has determined not to take any action against the City. The City has agreed to cooperate with Commission staff in preparing for and presenting any civil litigation or administrative proceedings concerning the transactions that are the subject of this Report.

By the Commission.